PUBLIC

NEW ENGLAND GAS COMPANY

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3459

BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

TESTIMONY AND EXHIBITS
OF DAVID J. EFFRON

ON BEHALF OF THE

DIVISION OF
PUBLIC UTILITIES AND CARRIERS

SEPTEMBER 30, 2002

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DIRECT TESTIMONY
OF DAVID J. EFFRON

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, telephone, gas and water rate filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in rate case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in over two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and Virginia.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Rhode Island Division of Public Utilities and Carriers ("the Division").

Q. What is the purpose of your testimony?

A. On August 1, 2002, New England Gas Company ("the Company") filed changes to various components of the Distribution Clause ("DAC"), pursuant to the Commission's approval of the Settlement in Docket 3401. The filing also addressed certain reconciliation elements related to the conclusion of the Energize Rhode Island Extension Settlement Agreement in Docket No. 2581 ("ERI-2"). The purpose of this testimony is to address the development of the ERI-2 Adjustment component of the DAC. In particular, I address the determination of the excess earnings element of the ERI-2 Adjustment. I also briefly address the Environmental Response Cost Factor being proposed by the Company.

Q. Please summarize your testimony.

A. Based on the information provided at the time of the preparation of this testimony, I have calculated that during the term of ERI-2, the former Providence Gas Company earned $2,687,000 of excess revenue. There are still information requests outstanding at the time of the preparation of this testimony. Based on the responses to the outstanding information requests, the amount of the calculated over-earnings could change. Therefore, I reserve the right to modify my quantification of over-earnings based on the responses to those information requests. Any excess earnings should be credited to the DAC for Providence Gas customers effective November 1, 2002. Any approval of the Environmental Response Cost Factor at this time should not be construed as a finding that the environmental costs themselves are prudent or reasonable.

III. ERI-2 ADJUSTMENT

Q. Please describe the ERI-2 Adjustment component of the DAC.

A. The ERI-2 Agreement established a deferred revenue account ("DRA"). The purpose of this account was to accrue certain items of revenue, which would be credited or charged to customers of the former Providence Gas Company at the end of ERI-2, June 30, 2002. These items were the effect of abnormal weather conditions on sales, sharing of margin on non-firm sales, and revenues producing earnings in excess of a 10.7% return on equity. The Settlement in Docket 3401 specified that the DRA balance as of June 30, 2002 would be a component of the DAC effective November 1, 2002. The DRA balance as of June 30, 2002 is the ERI-2 Adjustment component of the DAC.

Q. Did the ERI-2 Agreement specify how the return on equity should be calculated for the purpose of determining whether there were excess earnings to be credited to the DRA?

A. Yes. Paragraph II-I-2 of the ERI-2 Agreement states:

> The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base; where the net income available for common equity is equal to operating income adjusted to reflect Commission ratemaking principles less applicable interest and preferred dividends (if any) …

Q. Has the Company prepared an analysis of its earned return on equity over the term of ERI-2?

A. Yes. The Company has completed what it described as a "preliminary review" of its earnings from October 1, 2000 through June 30, 2002. Based on this preliminary review, the Company concluded that there were no excess earnings. To my knowledge, the preliminary review has not been modified or updated.

Q. Have you examined the preliminary review conducted by the Company?

A. Yes. The Company provided the preliminary review, along with supporting workpapers, in response to Division Data Request 1-06.

Q. Please summarize the results of the Company's preliminary review.

A. The Company calculated an earned return on common equity of 11.36% for the twelve months ended September 30, 2001 and 9.34% for the twelve months ended June 30, 2002. Since the average return on common equity for these two twelve-month periods, as calculated in the preliminary review, was less than 10.70%, the Company concluded that there should be no credit to the DRA for excess earnings during the term of ERI-2.

Q. Based on your examination, should the Company's calculation of its earned return on common equity for the period October 1, 2000 through June 30, 2002 be modified?

A. Yes. There should be several modifications to the Company's calculation of the earned return on common equity. These modifications affect both the determination of net income (the numerator) and the common equity supporting the utility rate base (the denominator) used in the calculation of the earned return on common equity.

Q. Have you recalculated the earned return on equity with your proposed modifications?

A. Yes. My calculation of the return on equity earned by the former Providence Gas Company during the term of ERI-2 is summarized on Schedules DJE-1 and DJE-2.

Q. Please explain these schedules.

A. On Schedules DJE-1, Page 1 and DJE-2, Page 1, I have begun in the first column with the return on equity as calculated by the Company. In the next column, I show my proposed adjustments; and in the third column, I show my calculation of the earned return on equity.

Q. Please explain your adjustment to income tax expense.

A. There are two modifications that I have made to the Company's calculation of income tax expense. First, the Company used a "pro forma" federal income tax rate of 38% in its calculation of income tax expense. Providence Gas used a federal income tax rate of 35% in the earnings report that was filed with the testimony that became the basis for ERI-2. Accordingly, a federal income tax rate of 35% should be used in calculating the federal income tax expense to be included in the determination of operating income.

Second, the Company has reclassified $455,000 of “below the line” income tax expense to operating expenses. The Company has provided no explanation of why it is appropriate to include this item in the operating federal income tax expense. Therefore, I have eliminated this item from the federal income tax expense. My calculation of income taxes is summarized on Schedule DJE-1, Page 2.

Q. Does that conclude your adjustments to operating income for the twelve months ended September 30, 2001?

A. Yes, for now. To calculate the net income for available for common equity, the interest expense must be subtracted from the net operating income.[1]

Q. Are you proposing any adjustments to the interest expense calculated by the Company?

A. Yes. The ERI-2 Agreement specifies that the interest expense is to be calculated by multiplying the rate base by the percentage debt in the capital structure times the applicable cost rate. As I explain below, I am proposing an adjustment to the rate base computed by the Company. This affects the interest expense. I am also proposing to modify the cost rate of debt used in the calculation of the interest expense.

1 There is no preferred stock in the Providence Gas capital structure subsequent to the acquisition by Southern Union.

Paragraph II-I-3 of the ERI-2 Agreement states, in part, that in determining the earned return on common equity:

> (I)f ProvGas' actual average common equity ratio is above 50% for any reporting period during the Extended Term, then the Company shall use a capital structure consisting of 50% debt and 50% equity.

This provision of the ERI-2 Agreement was in effect during the term of the extension. The Company assumed that the 50% debt in the capital structure was entirely long-term debt. However, the ERI-2 Agreement did not limit the 50% debt in the capital structure to long-term debt. Therefore, I believe a reasonable interpretation is that the intent was that the debt in the capital structure should include a mixture of long-term debt and short-term debt, as the Company's capital structure has traditionally contained such a mixture.

I have assumed 41.6% of the 50% debt in the capital structure is long-term debt, consistent with the capital structure presented for Providence Gas on a stand-alone basis in Docket No. 3401. I have assumed the remaining 8.4% of the 50% of debt consists of short-term debt, and I have used a cost rate of 4.86% for that short-term debt, as recommended by Division Witness Kahal in Docket No. 3401. The calculation of the cost of debt, with these assumptions, is shown on Schedule DJE-1, Page 2. The calculation of interest expense is shown on Schedule DJE-1, Page 1.

Q. What net income for available for common equity have you calculated?

A. I have calculated net income available for common equity of $13,188,000 (Schedule DJE-1, Page 1) for the twelve months ended September 30, 2001. This is the amount that should be divided by the balance of common equity to determine the earned return on equity.

Q. How did you determine the balance of common equity?

A. Paragraph II-I-2 of the ERI-2 Agreement states that in determining the earned return on equity:

> The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base. … The common equity applicable to rate base shall be calculated by multiplying the actual common equity ratio (subject to the limitations described above) by rate base. The rate base used in these calculations will be the average rate base for the relevant period, based on … established Commission ratemaking principles.

As the actual common equity ratio for Providence Gas was above 50%, the Company used a 50% common equity ratio to calculate the common equity supporting rate base, consistent with Paragraph II-I-3 of the ERI-2 Agreement. However, the rate base to which this common equity ratio is applied should be modified.

Q. What modification are you proposing to the rate base calculated by the Company?

A. The Company included prepaid expenses in rate base. Neither the rate base calculations accompanying the quarterly reports filed pursuant to ERI-1 nor the rate base determination in Docket No. 2286 included prepaid expenses in rate base. Therefore, the inclusion of prepaid expenses in rate base is not consistent with established Commission ratemaking principles for Providence Gas. Accordingly the prepaid expenses should be eliminated from rate base (Schedule

DJE-1, Page 3). This reduction to rate base in return reduces the common equity used in the denominator to calculate the return on common equity.

Q. With your changes to the net income available for common equity and the balance of common equity, what return on equity have you calculated for the twelve months ended September 30, 2001?

A. I have calculated that Providence Gas earned a 12.82% return on common equity for the twelve months ended September 30, 2001.

Q. Have you also recalculated the earned return on common equity for the twelve months ended June 30, 2002?

A. Yes. My calculation of the earned return on common equity for the twelve months ended June 30, 2002 is shown on Schedule DJE-2, Page 1. My modifications to the Company's calculation of the earned return on common equity for the twelve months ended June 30, 2002 are generally the same as my modifications for the twelve months ended September 30, 2001, with the exception of my proposed adjustment to operating expenses.

Q. What is your proposed adjustment to operating expenses?

A. In 2002, New England Gas Company incurred

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Based on the description of these expenses, they appear to be related to

and were not

necessary for the provision of utility service. Therefore I have eliminated the share of these expenses allocable to Providence Gas from the utility operating expenses incurred in the twelve months ended June 30, 2002.

In addition, I should point out that one of the areas still being investigated is the administrative and general expenses ("A&G") incurred for the twelve months ended June 30, 2002. The A&G incurred by Providence Gas was $29.2 million in that period, including the corporate allocation. This represents an increase of approximately 45% over the A&G expense for the twelve months ended September 30, 2001. It also represents an increase of approximately 25% over the A&G expense incurred by Providence Gas in the twelve months ended September 30, 2000, before the acquisition by Southern Union. This is especially unanticipated, as the representations made by the Company in Docket No. 3401 were that the acquisition would result in substantial reductions, not increases, to operation and maintenance expense, including A&G.

Q. With your changes to the net income available for common equity and the balance of common equity, what return on equity have you calculated for the twelve months ended June 30, 2002?

A. I have calculated that Providence Gas earned a 10.48% return on common equity for the twelve months ended June 30, 2002.

Q. Have you also calculated the excess revenue for the 21-month period from October 1, 2000 to June 30, 2002?

A. Yes, I have calculated the excess revenue over the ERI-2 term on Schedule DJE-3. The weighted average annual return on common equity[2] for this 21-month period was 11.65%. This exceeded the ceiling of 10.70% specified in ERI-2 by 0.95%, resulting in excess income of $977,000 per year. As the term of ERI-2 was 1.75 years, the excess income over this term was $1,710,000. This translates into excess revenue of $2,687,000 over the term of ERI-2.

Q. What should be done with this excess revenue?

A. Pursuant to the Settlement in Docket 3401, this excess revenue should be credited to the DAC applicable to customers of the former Providence Gas Company. Based on sales of 256,410,000 therms, this will reduce the DAC for former Providence Gas customers by $0.0105 per therm.

IV. ENVIRONMENTAL RESPONSE COST FACTOR

Q. Have you reviewed the Company's computation of the Environmental Response Cost Factor ("ERCF") component of the DAC?

A. Yes. The ERCF is a credit, meaning that the annual amount that the Company is seeking to recover beginning on November 1, 2002 is less than the $1,310,000 embedded in base rates.

Q. Are you proposing any modifications to the ERCF calculated by the Company?

[2] Weighted by the average balance of common equity

A. There should be one small correction to increase the costs recovered in rates through June 30, 2002 by $12,312 (response to DIV 1-01). This does not change the ERCF of ($0.0002) per therm.

Other than that, I am not proposing any modifications at this time. However, no review or analysis of the costs of the environmental projects for which the Company is seeking recovery has been conducted to verify the prudence and reasonableness of those costs. Therefore, if implementation of the ERCF calculated by the Company is approved, I recommend that the Commission should make clear that it is not making a finding that the costs of the environmental projects incurred through June 30, 2002 are prudent or reasonable or that a review of such costs in the future is precluded.

Q. Does this complete your testimony?

A. It does for now. However, as I stated above, it might be necessary to modify my quantification of over-earnings based on the responses to information requests outstanding at the time of the preparation of this testimony. If any such modifications are necessary, I will file supplemental testimony presenting those modifications and a revised calculation of excess revenue.